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No. 796

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN-LAFRANCE-FOAMITE CORPORATION,
PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3a–16a) [1] are not officially reported. The opinion of the Court of Appeals (Pet. 1A–6A) is reported at 284 F. 2d 723.

JURISDICTION

The judgment of the Court of Appeals was entered on December 13, 1960. (Pet. 7A.) The petition for a writ of certiorari was filed on March 10, 1961. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

[1] Record references are to the appendix to the taxpayer's brief, separately bound, filed in the Court of Appeals.

QUESTION PRESENTED

Whether the two courts below had basis for finding that advances made to a corporation by the taxpayer, a majority stockholder, were capital contributions and not loans, and that, accordingly, the taxpayer was not entitled to claim a bad debt deduction under Section 23(k) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (k) [As amended by Sec. 124(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Bad Debts.*—
>
> (1) *General rule.*—Debts which become worthless within the taxable year; * * *
>
> * * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts as found by the Tax Court (R. 4a–14a) may be summarized as follows:

Prior to December, 1941, Louis F. Fink conceived the idea of using two meters on one head and base to control two parking spaces, and applied for a patent covering the "plural parking space meter" (or "twin meter"). In December, 1941, Fink caused International Meters, Inc. ("I.M.I."), to be incorporated under the laws of the State of New York with an authorized capital of 400 shares of no par value preferred stock and 1,400 shares of no par

value common stock. (R. 4a.) On February 10, 1942, I.M.I. issued 600 shares of its common stock to Fink in consideration of the assignment by him to I.M.I. of the patent application covering the twin meter, and on the same day Fink was elected president. For the next five years the directors and officers of I.M.I. were selected and controlled by Fink. The patents applied for were issued in October, 1944. (R. 5a.)

In 1945 I.M.I. needed capital to organize and to begin to "tool up" and produce the twin meter. During that year Edward E. O'Neill, then president of American-LaFrance-Foamite Corporation (the taxpayer), became interested in the twin meter. (R. 5a.) The balance sheet of I.M.I. as of December 31, 1946, showed total current assets of about $790 and total current liabilities of about $62,900. (R. 6a–7a.) In February, 1947, the taxpayer purchased, for $50,000, 51% of the common stock of I.M.I., 400 shares of preferred stock, and I.M.I.'s note for $9,000. Shortly thereafter, O'Neill, president of the taxpayer, was elected president of I.M.I. (R. 8a.)

On February 21, 1947, the taxpayer entered into an agreement with I.M.I., which provided that the taxpayer would "loan" to I.M.I. without interest sufficient funds to take care of the operating expenses of I.M.I. during 1947, such as rent, light, telephone, salaries, advertising, traveling, and kindred expenses necessary in conducting its business for that year; and that I.M.I. would assign to the taxpayer the obligations of purchasers of the meters as collateral

for sums "owed" by I.M.I. to the taxpayer. Similar agreements were entered into by the taxpayer with I.M.I. in August, 1949, and January, 1951. (R. 9a-10a.)

The books of the taxpayer show balances of its unpaid advances to I.M.I. at the end of each year as follows (R. 11a):

Year	Balance
1946	$53,983.80
1947	98,717.20
1948	364,998.57
1949	534,748.24
1950	535,580.10
1951*	**575,987.08

*October 15, 1951.

**This balance at October 15, 1951, was subsequently adjusted between October 15 and December 17 so that immediately prior to complete liquidation the balance was $568,656.63. Application of cash, the sole remaining asset, amounting to $61,769.57 reduced the balance to $506,887.06.

During the years 1948, 1949 and 1950, and the period January 1 to October 15, 1951, I.M.I. sustained net losses of about $111,000, $122,000, $42,000 and $6,800, respectively. Its balance sheets showed capital deficits for those years in the amounts of about $120,000, $243,000, $286,000 and $272,000. (R. 12a.)

The operating contract between the taxpayer and I.M.I. was canceled by letter in July, 1951, effective in August, 1951. I.M.I. was liquidated shortly thereafter. During the liquidation of I.M.I., the taxpayer caused all of I.M.I.'s known debts to be paid. In some instances the taxpayer made advances to I.M.I. to enable it to pay creditors and in others it paid I.M.I.'s creditors directly and treated such payments as advances to I.M.I. (R. 13a.)

The taxpayer bought in all the assets of I.M.I. for $60,000, which amount was applied against the balance of advances made by the taxpayer to I.M.I.

(then about $568,000), leaving an unpaid balance of about $506,000. The taxpayer deducted the amount of about $506,000 on its income tax return for 1951 as a bad debt. (R. 14a.) The Commissioner determined a deficiency on the ground that the advances represented capital contributions and not loans. The Tax Court agreed that the advances were capital in nature and did not create debts, and the Court of Appeals affirmed.

ARGUMENT

1. In a case of this type, where the issue is whether advances made by a stockholder to a corporation represented capital contributions or loans, this Court has ruled, *John Kelley Co.* v. *Commissioner* (decided with *Talbot Mills* v. *Commissioner*), 326 U.S. 521, that the question is essentially one of fact (pp. 526–527) and that "[t]here is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts" (p. 530). The form of the transaction is not determinative of the question, and the taxpayer has the burden of proving by a preponderance of the evidence that the advances were not risk investments. *John Kelley Co.* v. *Commissioner, supra,* p. 530; *Arlington Park Jockey Club* v. *Sauber,* 262 F. 2d 902 (C.A. 7th); *Reed* v. *Commissioner,* 242 F. 2d 334, 335 (C.A. 2d); *Matthiessen* v. *Commissioner,* 194 F. 2d 659, 661 (C.A. 2d); *Schnitzer* v. *Commissioner,* 13 T.C. 43, 60, affirmed *per curiam,* 183 F. 2d 70 (C.A. 9th), certiorari denied, 340 U.S. 911; *Gregg Co. of Delaware* v. *Commissioner,* 239 F. 2d 498, 502 (C.A.

2d), certiorari denied, 353 U.S. 946; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Gilbert* v. *Commissioner*, 262 F. 2d 512, 513–514 (C.A. 2d), certiorari denied, 359 U.S. 1002; see *Rowan* v. *United States*, 219 F. 2d 51, 55 (C.A. 5th).

The evidence fully warrants the Tax Court's conclusion that the advances made here were risk investments. The record shows that, at the time the taxpayer became interested in the twin meter patent, I.M.I. had only a few assets, large debts, and no liquid capital; that I.M.I. needed capital to develop, produce, and market the meter; that the taxpayer was aware of this when it purchased a controlling interest in the stock of I.M.I. from Fink for $50,000; that the purpose of the advances was to get the business of I.M.I. established and to keep it in operation; that the advances were not evidenced by notes or other documents; that no time was fixed for their repayment and no interest was charged; that repayment was contingent upon the success of the business of I.M.I. and the possibility that the amount of its contracts assigned to the taxpayer would eventually equal the amount of the advances; and that I.M.I. sustained net losses and had mounting deficits during the period covered by the advances. There can be no basis, therefore, for disturbing the concurrent findings of the lower courts. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51; *Comstock* v. *Group of Investors*, 335 U.S. 211, 213–214.

2. Petitioner contends that the decision below "is in direct conflict with the decision of the United States

Court of Appeals for the Sixth Circuit in *Byerlite Corporation* v. *Williams*," decided December 15, 1960 (61-1 C.C.H., par. 9138).[2] In that case, the taxpayer, an Ohio corporation engaged in the manufacture and sale of asphalt and allied products, entered into a contract with the owner of a pitch pile, located on the Island of Aruba in the Netherlands West Indies, to remove the material in certain agreed quantities. The taxpayer expected to sell the material in Europe at a large profit and it formed a Canadian subsidiary (Byerlite Export Company, Ltd.) to extract asphaltic pitch from the pile and to process it for shipment. The taxpayer was to finance the whole project and to provide for the transportation and sale of the materials to third parties. It was to pay to the subsidiary all the expenses involved in removing the materials, preparing them for shipment and transporting them to a seaport; it was further to pay the subsidiary a service fee of $1.50 per ton above the expected cost of operations, and it was from this service fee that the taxpayer expected to receive back the advances made to the subsidiary to carry out its functions. The taxpayer's reason for organizing a subsidiary was to avoid subjecting all of its corporate resources to the liabilities of this particular transaction carried on under Dutch Colonial government.

Although Byerlite's subsidiary was authorized to issue 10,000 shares of $5 par value stock, it in fact issued only six shares, and those to the taxpayer,

[2] A few days after the instant petition was filed in this Court, the Government applied for an extension of time within which to file a protective petition in *Byerlite* in the event that the writ were granted in this case.

which advanced more than $564,000 to the subsidiary from 1947 through 1950. The debt-equity ratio was thus 18,800 to 1. These advances were treated on the taxpayer's books as loans, but there were no fixed maturity dates, no notes or other evidences of indebtedness, and no provision for interest. The expected markets did not materialize and the venture was a failure; the owner of the pitch pile terminated the contract in December, 1950, and in the same month the subsidiary was liquidated. The taxpayer treated the balance of the advances, about $467,000, as a bad debt, which it deducted on its 1950 return and part of which it deducted on its 1949 return as a carryback. The District Director disallowed the deduction on the ground that the advances were capital contributions for which no deductions were allowable. The District Court found as a fact that the taxpayer's advances to the subsidiary were contributions to capital, and not loans. The Sixth Circuit treated the question as one of fact and, upon the entire evidence surrounding the transaction and consideration of all indicia, came to the firm and definite conviction that the advances by Byerlite were loans, citing *United States* v. *Gypsum Co.*, 333 U.S. 364, 395, and *Peurifoy* v. *Commissioner*, 358 U.S. 59, 60–61. (Pet. 25A-26A.)

The decision of the Sixth Circuit in *Byerlite* thus turned on an evaluation of the particular facts of record. Although the Commissioner disagrees with the Sixth Circuit's conclusions in *Byerlite*, the facts in the two cases differ materially. There, for example, the parties anticipated that the advances

would be promptly repaid through the service fees to be retained by the subsidiary, and there was basis for the taxpayer's belief that its contract for removal of the asphaltic materials would be profitable and that the venture would last for only a short period. In the present case the taxpayer purchased 51% of the stock of an existing American corporation, whereas in the *Byerlite* case the taxpayer created a new Canadian corporation, because of its reluctance to risk all its resources in an operation in a foreign country under Dutch Colonial government, and owned all of the outstanding stock. In the present case, the Court of Appeals affirmed the findings and conclusions of the Tax Court, whereas the Sixth Circuit reversed the District Court in the *Byerlite* case.

Comparison of the two cases does not detract from the conclusion that the question "remains basically one of fact, for determination on a case-by-case basis" (*Commissioner* v. *Duberstein*, 363 U.S. 278, 290).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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